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In the

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1396

WILLIAM J. ROCHELLE, JR., Trustee,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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In the

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OCTOBER TERM, 1975

No. .....

WILLIAM J. ROCHELLE, JR., Trustee,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

William J. Rochelle, Jr., Trustee petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit.

OPINIONS BELOW

The opinion of the District Court in this case is reported in 371 F.Supp. 224.

The opinion of the Fifth Circuit Court of Appeals in this case is reported in 521 F.2d 844, and is attached hereto.

The opinion of the Court of Appeals granting Petitioner's Petition for Rehearing and amending the mandate to provide that the judgment of the District Court is affirmed in part and reversed and remanded in part is reported in 526 F.2d 405 and is attached hereto.

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JURISDICTION

(i) The original decision of the Court of Appeals in this case was entered October 24, 1975.

(ii) The Petition for Rehearing in this case filed by William J. Rochelle, Jr. was granted on January 26, 1976.

(iii) This Court has jurisdiction to review the judgment of the Court of Appeals for the Fifth Circuit by writ of certiorari pursuant to Title 28, U.S.C., Section 1254(i).

QUESTIONS PRESENTED FOR REVIEW

The primary question presented for review in this case is the holding of the Court of Appeals for the Fifth Circuit that a partnership creditor whose claim on the individual estate of a partner would be subordinated by §5(g) of the Bankruptcy Act to claims of individual creditors may nevertheless set off its claim against the individual estate's claim against the creditor. Simply stated, the question is this: *Whether setoff is available when the claim of the creditor is subordinated to other claims against the estate by §5(g).* The Court of Appeals answered the proposition in the affirmative. Petitioner contends that such holding is logically and legally wrong and that it conflicts with the decisions of another Court of Appeals.

Another very important question presented for review in this case is the holding of the Court of Appeals that tax obligations incurred by a debtor-in-possession which operates a partnership's business may be set off against the individual estate's claim against the creditor. Petitioner contends that such holding is not justified by any authorities, is manifestly unfair and unjust, and should not be permitted.

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A subsidiary question related to both of the main issues presented for review is whether, if set off is permissible, the partnership creditor must seek to exhaust the partnership estate.

STATUTES INVOLVED

(1) Bankruptcy Act, Section 5(g), 11 U.S.C. § 23(g); Sec. 5 Partners.

> (g) The net proceeds of the partnership shall be appropriated to the payment of the partnership debts and the net proceeds of the individual estate of each general partner to the payment of his individual debts. Should any surplus remain of the property of any general partner after paying his individual debts, such surplus shall be added to partnership debts. Should any surplus of the partnership property remain after paying the partnership debts, such surplus shall be distributed among the individual partners, general or limited, or added to the estates of the general partners, as the case may be, in proportion of their respective interests in the partnership and in the order of distribution provided by the laws of the State applicable thereto.

(2) Bankruptcy Act, Section 68, 11 U.S.C. § 108;

> § 68. Set-Offs and Counterclaims. a. In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.
>
> b. A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate and allowable under sub-division g of Section 57 of this Act, or (2) was purchased by or transferred to him after the filing of the petition or within four months before such filing, with a view to such use and with knowledge

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or notice that such bankrupt was insolvent or had committed an act of bankruptcy.

STATEMENT OF THE CASE

This case began as a plenary proceeding brought by Petitioner, Mr. Rochelle, the Trustee in Bankruptcy of the estate of Angus G. Wynne, Jr., for the refund of income taxes for the year 1962 in the amount of $326,947.92 (including interest). Federal jurisdiction was based upon 28 U.S.C. 1346(a)(1).

Mr. Wynne, the bankrupt, and Compass Fair, Inc., a New York corporation, formed a New York partnership (Wynn-Compass Fair, Inc.) to operate the Texas Pavillion at the New York World's Fair in 1964. While operating, the partnership incurred substantial liability for the employer's portion of Social Security taxes (FICA), for amounts withheld from employees pay for Social Security and income taxes, for Federal Unemployment Tax Act taxes (FUTA) and for excise taxes.

On July 16, 1964, the partnership filed a petition in the United States District Court for the Southern District of New York for an Arrangement with its creditors under Chapter XI of the Bankruptcy Act. Thereafter, the partnership business was operated under the administration of the Bankruptcy Court as a Debtor in Possession from July 16, 1964, to August 18, 1964, at which date the partnership was adjudicated a bankrupt.[1]

On September 3, 1964, an involuntary petition was filed against Angus G. Wynne, Jr. in the United States District

[1] The bankruptcy proceedings of Wynne-Compass Fair, Inc. are still pending in the Southern District of New York.

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Court for the Northern District of Texas.[2] Upon adjudication, Petitioner Mr. Rochelle was elected and qualified as the Trustee in Bankruptcy of the estate of Angus G. Wynne, Jr.

One of the assets listed on Mr. Wynne's bankruptcy schedules was a claim for refund of income taxes which Mr. Wynne had paid in 1962 based upon business losses he incurred in 1964. Mr. Rochelle took steps to perfect the refund claim for the benefit of the individual estate.[3] The Internal Revenue Service allowed the refund claim in the amount of $326,947.92. This amount, although allowed, was not paid to Petitioner. Instead, on August 1, 1968, the Internal Revenue Service credited the full amount to the unpaid withholding, FICA, FUTA and excise taxes incurred by the partnership (actually $88,280.28 of the amount set off was incurred not by the partnership but by the Debtor in Possession during its operation from July 16, 1964 until August 18, 1964).[4]

The Government resisted Petitioner's suit relying in part upon Section 68 of the Bankruptcy Act (11 U.S.C. § 108(a)) which permits a set-off in the case of mutual debts between the estate of a bankrupt and a creditor. Petitioner countered that set-off was impermissible because § 5(g) of the Bankruptcy

---

[2] This proceeding was dismissed and a second involuntary petition was filed against Wynne on November 20, 1964. The actual date of Wynne's bankruptcy is yet to be determined. See *Wynne v. Rochelle*, 385 F.2d 789 (5th Cir. 1967).

[3] Pursuant to *Segal v. Rochelle*, 382 U.S. 375 (1966) (holding loss carryback refund constituted property which passed to Trustee in Bankruptcy).

[4] A portion of the refund claim was credited to penalty items. The question of the propriety of set off of penalty items is not before the Court at this time.

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Act subordinated the Government's claim (as well as those of all other partnership creditors) to the claims of the individual creditors with respect to assets of the individual estate.[5]

The District Court found in favor of the Government, holding that the partnership taxes unlike other partnership claims would not be subordinated by § 5(g) to the individual creditors in the individual estate (i.e. the Government was entitled to prove its claim in both the partnership and individual estate) and therefore that set-off was proper.[6]

The Court of Appeals, although concluding that § 5(g) would subordinate the unpaid partnership taxes to the claims of the individual creditors, nevertheless affirmed the District Court by holding that a subordinated claim could be the basis of a set-off under § 68 of the Bankruptcy Act.

Both the District Court and the Court of Appeals conclud-

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[5] The Trustee of the partnership estate had no claim to the refund even though the refund claim was largely based upon losses of the partnership, since the Federal Income Tax Law considers a partnership as a mere conduit with the partners picking up the gains or losses on their own returns. The employment and excise taxes, on the other hand were actual liabilities of the partnership as such. See e.g. *Young v. Riddell*, 283 F.2d 909 (9th Cir. 1960).

[6] The District Court also found in favor of the Government on the alternative ground that the Trustee was estopped to contest the set-off because he had previously signed a Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) which provided that the allowed refund would be credited to the unpaid Federal taxes due from Angus G. Wynne, Jr. and Compass Fair Inc., Petitioner strongly challenged this ground on appeal urging that uncontradicted evidence established (1) Petitioner unwittingly signed the Form 870 (which was actually prepared by the Bankrupt's C.P.A.) (2) The agreement was not authorized by the referee in bankruptcy as required by § 27 of the Bankruptcy Act and therefore was not binding on the estate (3) the Government was not prejudiced by Petitioner's execution of the Form 870. Since the Court of Appeals declined to decide this issue it is not before the court at this time.

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ed that the unpaid taxes which were incurred by the Debtor in Possession during the Chapter XI proceedings were also properly set-off against the refund claim. Both also declined to require the Government to seek payment on its claim from the partnership estate.

ARGUMENT

I.

WHETHER SETOFF IS AVAILABLE WHEN THE CLAIM OF THE CREDITOR IS SUBORDINATED TO OTHER CLAIMS AGAINST THE ESTATE BY SECTION 5g.

The question presented should be resolved by this Court because it involves an important question of Bankruptcy Law which has not been, but should be, settled by this Court and upon which the Circuit Courts are in conflict.

The decision of the Fifth Circuit Court of Appeals resolved an apparent conflict between the policies of § 5(g) and § 68 of the Bankruptcy Act in favor of § 68.

Section 5(g), 11 U.S.C. § 23(g) gives priority in the allocation of the assets of a bankrupt partner to individual creditors of the partner over creditors of the partnership.[7] Section 68, 11 U.S.C. § 108 permits the setoff of mutual debts or credits between the estate of a bankrupt and a creditor.

The Court of Appeals recognized that the United States was a partnership creditor for purposes of Section 5(g) and

[7] *In re Wilcox*, 94 F. 84 (D. Mass. 1899) contains an exhaustive historical treatment of the development of the rule of distribution presently embodied in Section 5(g).

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that accordingly its claim for the unpaid partnership taxes would be subordinated to the claims of the individual creditors in allocating the assets of the individual estate.

Nevertheless, the Court of Appeals further held that Section 68 of the Bankruptcy Act permitted the United States to setoff the partnership taxes against the refund claim due the individual estate even though the partnership tax claim could not otherwise have shared in dividends from the individual estate.

> "We think a subordinated claim can be used to setoff a claim by the bankrupt estate against the creditor even though the subordinated claim could not itself share in the dividends. And we think this rule is applicable where the claim is subordinated by operation of § 5(g)."

This holding is directly contrary to the following decisions in the Second Circuit:

> *In re Neaderthal*, 225 F. 38 (2d Cir. 1915)
>
> *In re Sherman Plastering Corp.*, 346 F.2d 492, 495 (2d Cir. 1965):
>
> > "Such a setoff would be unfair to the individual creditors of the bankrupt partner under the rule of distribution providing that the individual creditors, as opposed to partnership creditors, should have first claim on the bankrupt partner's individual estate."[8]

This Court has never decided the question presented by this case. The closest case to be decided by this Court was *Tucker v. Oxley*, 9 U.S. (5 Cranch) 34, 1809) in which Chief Justice

[8] The Court of Appeals characterized this statement as dictum since the question before the Court did not involve a partnership or any question under § 5(g). Nevertheless, the statement clearly reflects the view of the Second Circuit since it was made after very exhaustive research and analysis.

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Marshall held that under the Bankruptcy Act of 1800 a partnership creditor could setoff its claim against the debt which it owed the estate of an individual partner. *Tucker v. Oxley*, however, is by no means authority for the Fifth Circuit's decision in this case[9] since the Bankruptcy Act under which it was decided (the Act of 1800) did not contain an equivalent to the present day § 5(g).[10] Petitioner has maintained throughout that the reasoning of this Court in *Tucker v. Oxley* firmly supports his position. The basis of this Court's decision in *Tucker v. Oxley* permitting setoff was the determination that partnership creditors (under the Bankruptcy Act of 1800 which contained no equivalent to the present Act's § 5(g)) were permitted (once the partnership estate had been exhausted) to share in dividends from the individual estate on an equal footing with individual creditors. In other words, implicit in this Court's decision in *Tucker v. Oxley* was the assumption that the question of whether or not the set-off was permissible depended upon the question of whether the partnership creditors could participate in dividends from the individual estate on an equal basis with individual creditors.

The result of the Court of Appeals' decision was to permit the appropriation of the largest asset of the individual estate exclusively for the benefit of a single partnership creditor. To accept this result, this Court must conclude that the same

[9] In fact, the Court of Appeals did not cite *Tucker v. Oxley* in support of its ultimate con clusion that setoff is abailable when the creditor's claim is subordinated to other claims against the estate by § 5(g). It did, however, cite the case in support of its determination that the claims of the United States and Petitioner constituted mutual debts within the meaning of Section 68.

[10] The Act of 1800 did have an equivalent to the present § 68.

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Congress that intended to subordinate partnership claims to assets of the individual estate by Section 5(g) also intended by Section 68 of the same Act to permit partnership claims to be satisfied from assets belonging to the individual estate through a setoff.

The Court of Appeals justified its decision by a narrow legalistic analysis of Section 68, relying heavily on the maxim of *expressio unius est exclusio alterius.* The Court then concluded that Section 68 generally permitted setoff of subordinated claims, citing *Hayden v. Standard Accident Insurance Co.,* 316 F.2d 598 (9th Cir. 1963) (holding that a surety whose claim for indemnification was subordinated by § 57(i). 11 U.S.C. § 93(i) could nonetheless set-off its claim for indemnification against its own debt to the estate).

Other Circuit Courts have rejected the approach of the Fifth and Ninth Circuits in determining the scope of § 68:

Bayless v. Rood,[11] 424 F.2d 142, 147 (4th Cir. 1970)

In re Brewster Raymond Company,[12] 344 F.2d 903 (6th Cir. 1965)

This Court should grant certiorari in order to resolve the important question presented.

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[11]Holding that a contractually subordinated debt cannot form the basis of a setoff.

[12]Holding that penalty items cannot be used for setoff. The Court rejected the argument that penalties could be collected through a setoff although they could not otherwise share in dividends from the estate since they were provable claims and, although not allowable, were not disallowable by § 57(g). Note that the Court of Appeals did not extend its analysis of § 68 as far as to permit the setoff of penalty items. See opinion order granting rehearing, appendix.

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II.

WHETHER THE TAXES INCURRED BY THE DEBTOR - IN - POSSESSION CAN BE SETOFF AGAINST THE INCOME TAX REFUND DUE PETITIONER.

As indicated above, a substantial amount ($88,280.28) of the allowed refund claim was credited by the IRS to the unpaid taxes incurred by the Debtor-in-Possession which operated the partnership business from July 16, 1964 until August 18, 1964.

Both the District Court and the Appeals Court assumed without citing any reasons or authority that the Debtor-in-Possession was a kind of alter ego or continuation of the partnership and accordingly that (1) Mr. Wynne remained liable as a partner for obligation incurred by the Debtor-in-Possession and (2) such obligations could be setoff against the refund claim due the individual estate to the same extent as obligations incurred by the partnership, Wynne-Compass Fair, Inc. The Appeals Court in explaining its decision on this point stated merely:

> "Since a debtor-in-possession is liable for new debts it incurs, there is no plausible reason why others jointly or jointly and severally liable for the debts of the Debtor-in-Possession should not also be liable for such debts."

It is well established that taxes incurred during a Chapter XI proceeding by a Debtor-in-Possession ordinarily constitute administrative expenses entitled to the first priority in payment. See *3A Collier, Bankruptcy,* Section 62.4 at p. 1529.

Thus the result of the Court of Appeals' decision was to

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force the individual estate to pay administrative expenses incurred by the partnership estate. This result is manifestly unfair — the Chapter XI proceeding being solely for the benefit of the partnership creditors and the individual creditors having no standing to object to the continuation of the business and increasing debts.[13]

The decision of the Court of Appeals confuses the Debtor (Wynne-Compass Fair, Inc.) and the Debtor-in-Possession in its holding that Mr. Wynne remained jointly and severally liable as a partner for taxes incurred by the Debtor-in-Possession. In fact, a Debtor-in-Possession is not a partnership at all. It is a seperate and distinct entity, with all the powers and duties of a Trustee in Bankruptcy. *Shopmen's Local Union No. 455 v. Kevin Steel Prod., Inc.*, 519 F.2d 704 (2d Cir. 1975).[14]

When a Chapter XI proceeding is filed, there is always a debtor, but not always a Debtor-in-Possession. Depending upon various factors there may instead be a Receiver or Trustee.[15] Whichever there is, that entity becomes the officer of the Court, subject to the complete and exclusive control

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[13]In addition to the unfairness of requiring one estate to pay administrative expenses of another estate, the decision has other disturbing implications: Is an individual partner liable for taxes incurred by a Receiver or Trustee who operates the partnership business? Must an adjudicated partner now ascertain and schedule all unpaid expenses of administration incurred in a prior partnership proceeding. Is a bankrupt in an ordinary bankruptcy, by analogy, liable for administrative expenses in his own proceeding?

[14]There is an excellent and exhaustive treatment of this distinction and its ramifications in 8 *Collier, Bankruptcy* §§ 6.25 - 6.39.

[15]The Bankruptcy Judge makes this determination at the outset, Rule 11-23, *Bankruptcy Rules.*

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of the Bankruptcy Court, 11 U.S.C. § 743. While the judicial officer performs its function,[16] the Debtor also has an active role to play, particularly in formulating the Plan of Arrangement which it will present to its creditors. If the business of the Debtor is operated during the Chapter XI proceedings, it can only be done by the judicial officer — the Debtor may not operate.

The tax obligations which accrued during the Chapter XI proceedings were incurred by the Debtor in Possession (not the Debtor) operating pursuant to Court Order. Mr. Wynne was a general partner of the Debtor, Wynne-Compass Fair, Inc. He was not a general partner of the Debtor-in-Possession. Since the Debtor and the Debtor-in-Possession are separate entities, and since Mr. Wynne was a partner only of the Debtor, the issue of Mr. Wynne's liability for obligations incurred by the Debtor-in-Possession is not the simple one of joint and several liability of the individual partner for all partnership debts. Thus the agency of partnership law no longer suffices without more to establish liability. If liability is to be imposed it must be founded on some other legal principle which imposes liability on an individual partner for obligations incurred during Court administration of the partnership's business. Petitioner has found no such authority and the Court of Appeals cited none.

Even if Mr. Wynne were liable for the taxes incurred by the Debtor-in-Possession, it would not follow that setoff would

[16]To take title to all assets and, normally, to operate the business of the Debtor.

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be proper since the mutuality requirement of § 68 would be lacking between the two claims. It is well-established that a creditor of a Debtor-in-Possession (or a Receiver) cannot setoff its claim against a debt incurred by the Debtor prior to institution of Chapter XI proceedings. *Standard Oil Co. of New Jersey v. Elliott,* 80 F.2d 158, (4th Cir. 1935); *Wasson v. White,* 12 F.2d 809 (D.C. Okla.)

Thus, since the Debtor-in-Possession was sufficiently separate from the partnership to destroy mutuality, it would follow that the Debtor-in-Possession and Mr. Wynne were likewise sufficiently separate to destroy mutuality for purposes of Section 68.

This Court should grant certiorari to resolve the question presented in order to dispel the confusion in the administration of bankruptcy matters which the opinion of the Court of Appeals will generate.

III.

WHETHER THE GOVERNMENT MUST EXHAUST THE PARTNERSHIP ESTATE.

As an alternative argument, Petitioner has contended that if setoff is permissible, §5(g) at least requires that the United States seek to collect as much of its claim as possible from the partnership estate and that only the balance be setoff against the refund claim due Petitioner. In this respect, it is obviously unfair for the United States to receive any payment from assets of the individual estate to the extent that funds are available for payment out of the partnership estate. The

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Court of Appeals disposed of this contention summarily with no dicussion.

This Court in *Tucker v. Oxley*, 9 U.S. (5 Cranch) 34 (1809) recognized that even in the context of a setoff partnership creditors were required to exhaust the partnership assets.

As stated above, the question of whether the United States must exhaust the partnership estate is very much related to the primary questions presented for review and for the same reasons cited above should be included in this Court's consideration of the case.

WHEREFORE, your Petitioner respectfully prays that a writ of certiorari be issued to the United States Court of Appeals for the Fifth Circuit to the end that this cause may be reviewed and determined by this Court, that the decree of the Court of Appeals for the Fifth Circuit be reversed, and that Petitioner be granted such other and further relief that may be proper.

Respectfully submitted this ..... day of March, 1976.

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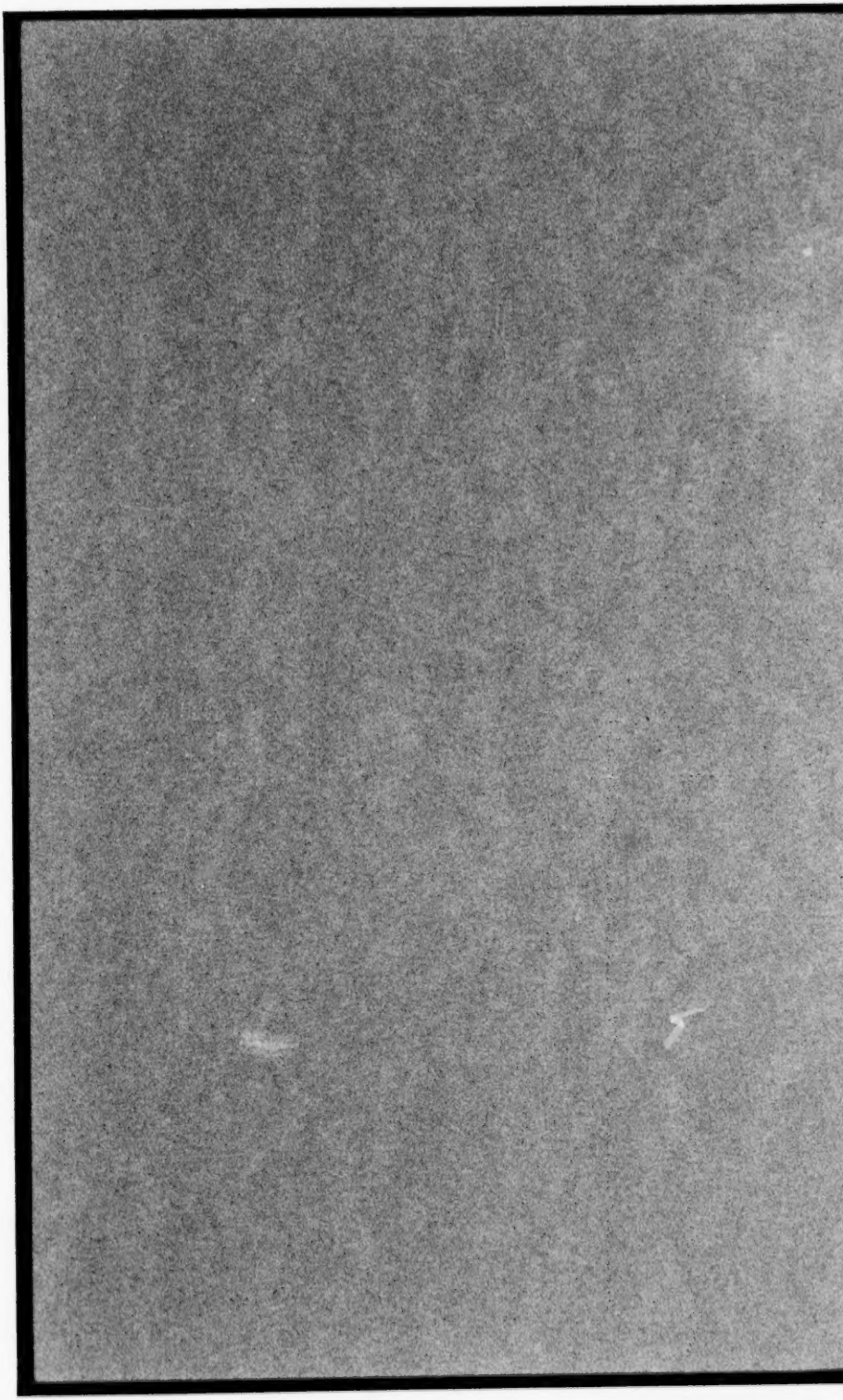
APPENDIX



UNITED STATES COURT OF APPEALS
For the Fifth Circuit
Office of the Clerk

February 20, 1976

Ms. Linda N. Coffee
Attorney at Law
2130 First National Bank Bldg.
Dallas, Texas 75202

No. 74-1639 — William J. Rochelle, Jr.,
Trustee v. U. S. A.

MANDATE STAYED TO AND INCLUDING
March 21, 1976

Dear Counsel:

The Court has this day granted a stay of the issuance of the mandate to the date as shown above. If during the period of the stay there is filed with the clerk of this court a notice from the clerk of the Supreme Court that the party who has obtained the stay has filed a petition for the writ in that court, the stay shall continue until final disposition by the Supreme Court. Upon the filing of a copy of an order of the Supreme Court denying the petition for writ of certiorari the mandate shall issue immediately under Rule 41, FRAP.

Under revised Rule 21(1) of the Supreme Court effective July 1, 1970, a record is no longer required in connection with an application for writ of certiorari, and therefore will not be routinely prepared by this office (39LW 3502).

A copy of the opinion, judgment and opinion order on rehearing are still required by the Supreme Court to be incor-

porated as an appendix to your petition. Enclosed are copies of the said documents which have been entered in this cause.

Very truly yours,

EDWARD WADSWORTH, Clerk

By Mary Beth Breaux

Deputy Clerk

enc. cc.

Mr. Philip I. Palmer, Jr.
Ms. Martha Joe Stroud
Mr. Lawrence R. Jones
Mr. Meyer Rothwacks
Mr. Michael D. Cropper
Mr. Frank D. McCown
Mr. Karl Schmeidler
Mr. Scott P. Crampton
Mr. Charles G. Barnett
Mr. Joseph M. McManus

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UNITED STATES COURT OF APPEALS

For the Fifth Circuit

William J. Rochelle, Jr., Trustee,
Plaintiff-Appellant,

v.

United States of America,
Defendant-Appellee.

No. 74-1639

Oct. 24, 1975

Appeal from the United States District Court for the Northern District of Texas.

Before RIVES, GODBOLD and GEE, Circuit Judges.

GODBOLD, Circuit Judge:

This case involves the interplay of two sections of the Bankruptcy Act. Section 5g, 11 U.S.C. §23g,[1] gives priority in the allocation of the assets of a bankrupt partner to creditors of the partner over creditors of the partnership. Section 68a,

[1]Section 5g provides:

"The net proceeds of the partnership property shall be appropriated to the payment of the partnership debts and the net proceeds of the individual estate of each general partner to the payment of his individual debts. Should any surplus remain of the property of any general partner after paying his individual debts, such surplus shall be added to the partnership assets and be applied to the payment of the partnership debts. Should any surplus of the partnership property remain after paying the partnership debts, such surplus shall be distributed among the individual partners, general or limited, or added to the estates of the general partners, as the case may be, in the proportion of their respective interests in the partnership and in the order of distribution provided by the laws of the State applicable thereto."

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11 U.S.C. §108a,[2] permits a creditor of a bankrupt who also is in debt to the bankrupt to set off the two debts against each other, claiming or paying only the balance.

In this case the United States is a creditor of a bankrupt partnership, Wynne-Compass Fair, Inc. The United States seeks to set off against the claim running to it as a partnership creditor a claim asserted on it by the bankruptcy estate of a partner of Wynne-Compass Fair, Inc.[3]

We hold that the claim of the United States against the estate of the partner, based upon the partnership obligation, is subordinated by § 5g to the claims of creditors of the partner in his individual capacity. But we further hold that this subordination of the United States' claim under § 5g does not bar the United States from utilizing the set-off provisions of § 68a, which is available for provable claims even though they are not allowable.

An individual, Wynne, and a New York corporation, Compass Fair, Inc., formed a New York partnership, Wynne-Compass Fair, Inc., to operate the Texas pavilion at the

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[2]Section 68a provides:

"In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid."

Section 68b, which modifies and limits §68a, provides in pertinent part:

"A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate and allowable under subdivision g of section 93 of this title [§57g] . . ."

[3]We will follow the standard practice and describe the creditors by the estate against which they claim: an individual creditor is a creditor who claims against the estate of the individual partner and a partnership creditor is a creditor who claims against the estate of the partnership.

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1964 New York World's Fair. The partnership proved unsuccessful. It filed for a Chapter XI arrangement in July 1964 and was adjudicated a bankrupt in August 1964. In September an involuntary petition in bankruptcy was filed against Wynne, and in November he was adjudicated a bankrupt. The United States filed against the estate of both the partnership and of Wynne, the general partner, proofs of claim for the partnership's unpaid federal employment (withholding, FUTA and FICA) and excise taxes.

In November 1967 Wynne and his wife, who had filed a joint federal income tax return in 1962, claimed a refund of $326,947.92 of their 1962 income tax by a carryback of the 1964 partnership loss. The claim was allowed in full by IRS. Rochelle, the trustee of Wynne's bankruptcy estate, now claims the refund on behalf of Wynne's individual creditors. The United States resists, asserting under § 68a a right to set off the refund against the unpaid tax liability of the partnership. Put in practical terms, the trustee would have the United States pay the tax refund into Wynne's individual estate and wait in line with other creditors in either or both of the partner and partnership bankruptcy proceedings to collect the unpaid tax debts of the partnership. Presumably the United States would not be able to recoup even the amount of the tax refund paid in, let alone the total tax debt of the partnership. The District Court held that the government had the right to set off the two debts and trustee Rochelle has appealed.[4]

[4]Prior to this proceeding Rochelle consented in writing to the setoff and now attempts to back out of his consent. In light of our disposition of the case we need not consider the effect of this consent.

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This appeal presents the following questions:

(I) What is the effect of § 5g on the United States' tax claim against the individual estate of the partner Wynne,

(II) Does § 68a authorize offset between the government's claim against the bankrupt — as affected by § 5g — and its liability for a tax refund?

(A) Are the claims "mutual"?

(B) Is the United States' claim "provable" and is it "allowable" under § 57g, 11 U.S.C. § 93g?

(C) Does § 68a allow offset of subordinated claims?

I. Section 5g

[1] The United States argues that § 5g "relates to priorities of payment between classes of creditors, and provides a rule of distribution; it does not alter the status of one who is a creditor of both the partnership and the partner." And, the government says, since it enjoys the status of creditor of both partner and partnership, it may, under § 5g, share in the partner's estate as a creditor of that estate.

[2] We agree with the government that its tax claim against the partnership is also a personal liability of the partner. But the claim did not begin that way. The partnership was formed in New York, and under New York partnership law, N.Y.P.L. § 26(1) (McKinney's, 1948), partners are jointly and severally liable only for partnership liabilities under N.Y.P.L. §§ 24 and 25. These include liability for wrongful acts in the course of business or with the partners' authority under § 24 and liability for breaches of trust by misapplication of funds under § 25. All other liabilities of the partnership — including tax

debts — are only joint liabilities of the individual partners, N.Y.P.L. § 26(2) (McKinney's, 1948). The partners' individual or several liability arises when "the property held jointly is insufficient to pay the firm debts, or it appears that there can be no effective remedy without resort to individual property. . . . The theory of the law was that the joint liabilities should be paid from the joint property if possible, and not until that remedy was exhausted, or resort thereto shown to be useless, could payment from the individual property be exacted." *Seligman v. Friedlander*, 199 N.Y. 373, 376, 92 N.E. 1047, 1048 (1910) (citations omitted).[5] It is in this sense, then, that when a partnership is adjudicated a bank-

[5]New York courts have held specifically that the individual partners become severally liable for the debts of the partnership when the partnership assets are exhausted. *Matter of Roberts*, 214 N.Y. 369, 108 N.E. 562 (1915); *see also Friedman v. Gettner*, 6 App.Div.2d 647, 180 N.Y.S.2d 446 (1958), *aff'd*, 7 N.Y.2d 764, 194 N.Y.S.2d 35, 163 N.E.2d 141 (1959); *Morrisey v. Berman*, 47 Misc. 586, 94 N.Y.S. 596 (1905). They have rarely had to decide what circumstances will give rise to the partners' several liability before final distribution of assets. The reason for this is that when an action on a partnership debt is brought against a partner, bankruptcy usually already has intervened and the rule of marshalling of assets, as embodied in the federal bankruptcy law, §5g, then controls. *See Matter of Gray*, 111 N.Y. 404, 408, 18 N.E. 719 (1888). New York courts have held that mere default by the remaining active partner does not subject the retired partner to liability, *Morrisey v. Berman*, *supra*. Similarly, unsatisfied execution on a judgment against the partnership also does not give rise to the partners' several liability. *Everall v. Stevens*, 158 App.Div. 723, 143 N.Y.S. 874 (1913). The closest case is *Freidman v. Gettner*, *supra*, in which the court held that failure to allege "insolvency or inability to pay on the part of the surviving joint venturers" was a fatal pleading error. Joint ventures were considered identical to general partnerships. In light of the language in *Seligman* quoted above and the implication in *Friedman* that an allegation of insolvency would be adequate, we think it proper to hold that New York law would find the partners severally liable for the debts of the partnership once the partnership is adjudicated bankrupt though prior to actual distribution of assets.

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rupt or its assets are exhausted that all partnership creditors become creditors of the individual partners.

The United States cites cases to illustrate that tax liabilities of a partnership are also the individual liabilities of each partner. It further asserts that its tax claim against the partner is "not solely derivative upon its failure to obtain satisfaction of its claim against the partnership, instead, Wynne . . . is individually liable . . . whether there are sufficient assets available in the partnership estate." We take it that the government is suggesting that its tax claim, insofar as assertable against the partner's estate, enjoys a better status than the claims of other partnership creditors. But every case cited by the government for this argument relies on the syllogism that partners are liable for the debts of the partnership, tax liabilities are debts of the partnership, therefore the partners are liable for the tax debts.[6] Moreover, in every case the government's claim against the individual partner was pressed only after the bankruptcy of the partnership or its failure to pay the taxes due. In *Adams* the court refers to the partner's joint — not joint and several — liability, 228 F.Supp. at 232, and in *Ross* the court noted the creditor's duty to pursue the partnership assets before turning to a retired partner, 176

[6]*Underwood v. U. S.*, 118 F.2d 760, 761 (CA5, 1941); *Young v. Riddell*, 283 F.2d 909, 910 (CA9, 1960), *aff'g.* 60-1 U.S.T.C. par. 9381, p. 76,054 (S.D.Cal., 1959); *Adams v. U. S.*, 328 F.Supp. 228 (D.Neb., 1971), relies on *Underwood v. U. S., supra; U. S. v. Ross*, 176 F.Supp. 932, 935 (D.Neb., 1959); *In re Crockett*, 150 F.Supp. 352 (N.D.Cal., 1957); *Baily v. U. S.*, 350 F.Supp. 1205 (E.D.Pa., 1972), relies on *Young v. Riddell, supra; American Surety Co. v. Sundberg*, 58 Wash.2d 337, 363 P.2d 99 (1961), relies on *Underwood v. U. S., supra*, without discussion. *Purvis v. U. S.*, 73-2 U.S. T.C. par. 9628 (CA9, 1973) is a summary affirmance with no discussion of facts or citations to any authority.

F.Supp. at 935. Indeed, the government lost in *Ross* exactly because the partner, then retired but active when the tax debt was incurred, was only a surety, and the government failed to protect his interest by retaining a lien for his benefit on the principal debtor's assets. Thus these cases not only do not support the government's claim that Wynne was liable even if there were sufficient partnership assets, they actively refute it.[7] Whatever the status of the United States' claim against the bankrupt individual partner for the purposes of § 5g, it is no different than that of any other creditor of the bankrupt partnership.

Section 5g draws only one distinction, that between partnership creditors and individual creditors. It permits all individual creditors as a class to share on an equal basis in the individual estate while relegating all partnership creditors as a class to a subordinate position in claiming against the individual estate. We think the drafters would not have drawn balanced, logical distinction if they meant one class — individual creditors — to include as well every member of the other class — partnership creditors.

This circuit has already ruled squarely on this proposition. In *In re Hurley Mercantile Co.*, 56 F.2d 1023 (CA5, 1932), we held that although "each partner is individually liable for every partnership debt," for bankruptcy act purposes

> the partnership with its property and debts is considered

[7]The United States does not rely on any theory that its tax claim has statutory priority over other creditors' claims, *cf., Lewis v. U. S.*, 92 U.S., 618, 620-621, 23 L.Ed. 513, 514 (1876); *In re Vetterlein & Co.*, 20 F. 109 (S.D.N.Y., 1884), in particular under §64a(5) of the Bankruptcy Act, 11 U.S.C. §104a(5).

> a separate entity from the partners with their several estates and creditors. The Bankruptcy Act requires them to be kept separate for administration, and that partnership assets be first applied to partnership debts, and individual assets to individual debts. Bankr.Act § 5 (11 U.S.C.A. §23).

56 F.2d at 1025. *See Farmers' & Mechanics' Nat. Bank of Phila. v. Ridge Ave. Bank*, 240 U.S. 498, 36 S.Ct. 461, 60 L.Ed. 767 (1916). To the same effect, see *e.g., In re Janes*, 133 F. 912 (CA2, 1904); *In re Knowlton & Co.*, 202 F. 480, 482 (CA3, 1913); *Bank of Reidsvile v. Burton*, 259 F. 218, 219 (CA4, 1919); *Cutler Hardware Co. v. Hacker*, 238 F. 146, 147 (CA8, 1916). We know of no case to the contrary. See 1A Collier on Bankruptcy §5.26 at 734.2 - 736. Even reducing a partnership claim to judgment against the partner does not alter the result, *id.* at 736 n. 6. Thus the government's tax claim on the partnership, like every other partnership debt, is subordinated to the claims of individual creditors by § 5g.

In support of its argument that partnership debts on which the individual partner's liability has matured are to be treated as individual debts under § 5g, the government says it should be permitted recovery against both estates, so-called double proof,[8] and cites in support thereof § 5h, 11 U.S.C. § 23h, and *Mitchell v. Hampel*, 276 U.S. 299, 48 S.Ct. 308, 72 L.Ed. 582 (1928). Under this argument if a partnership and a general partner both brankrupted and each estate paid 50 cents on the dollar, the partnership creditors would be paid in full, getting 50 percent from each estate, while individual creditors

[8]Not to be confused with the problem of double proof under §63, 11 U.S.C. §103. *See* 3A Collier on Bankruptcy §63.02[2] at 1779, distinguishing this from double proof against partners and partnerships.

whose claims did not derive from partnership liabilities would receive but 50 percent.

Section 5h does not authorize allowance of such double claims but merely "remove[s] all arbitrary rules of practice and procedure which had interfered with the distribution of the estates of bankrupt partnerships and partners, in accordance with the settled rules of equity." 1A Collier on Bankruptcy § 5.22 at 730, n. 2, citing *Farmers' & Mechanics' Nat. Bank of Phila. v. Ridge Ave. Bank, supra* and *In re Effinger*, 184 F. 728 (D.Md., 1911). Indeed, Collier specifically notes that

> [T]he rule of equitable distribution prescribed by § 5g is not to be varied by the proof of the claim of a partnership estate against an individual estate and *vice versa*, as set forth in § 5h.

1A Collier on Bankruptcy § 5.22 at 731.

The government's reliance on *Mitchell v. Hampel* is likewise misplaced. It is one of a series of cases in which partnership and partner have distinct but common liabilities. See the cases cited in 1A Collier on Bankruptcy § 5.35 at 751, n. 7. Collier broadly characterizes as joint and several certain situations where both partner and partnership are liable *in solido*, but in fact the cases represent only a few distinct types of common liability and not joint and several liability generally. In *Mitchell* the partners co-signed a bond of the partnership, rendering them liable jointly and severally as sureties individually, in addition to their liability as members of the partnership. The other cases involved liability of the partners not

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derived from the partnership liability,[9] liability of the partnership as recipient of funds improperly taken by a partner,[10] or special priority of the creditor derived from statute.[11]

In light of these authorities we think it clear that the term "individual debts" in § 5g refers to debts of the individual partner not imposed upon him derivatively as a result of partnership debts. Section 5g thus subordinates a partnership creditor — even though it is also an individual creditor in that it owns a claim against general partners imposed on the partners because of a partnership liability — to other kinds of individual creditors in the allocation of the assets of the estates of the individual partners.[12] This result is not varied where the debt is a tax liability owed to the United States and no statute gives special priority.

II. Section 68

[3] Holding that the government's claim is subordinated to

[9]*Robinson v. Seaboard National Bank of New York*, 247 F. 667 (CA3, 1918), *aff'g, In re W. S. Kuhn & Co.*, 241 F. 935 (W.D.Pa., 1917) (partners liable as endorsers of the partnership's note); *In re McCoy*, 150 F. 106 (CA7, 1906) (same).

[10]*In re Coe*, 183 F. 745 (CA2, 1910) (partnership liable in tort for conversion); *In re Jordan*, 2 F. 319 (D.Maine, 1880) (trust *ex maleficio* from knowing use of assets subject to a trust).

[11]*Lewis v. U. S.*, 92 U.S. 618, 23 L.Ed. 513 (1876) (priority of certain federal tax claims); *In re Vetterlein & Co., supra* (same).

[12]There may be situations in which there is doubt whether a debt is a partnership or individual debt. *See* 1A Collier § 5.30. Whatever ambiguity may be inherent in these terms they pose no problem in the instant case. The tax liabilities resulted from the activities of the partnership and were incurred by the partnership in the first instance. The partner may be liable, but his liability is only that of any partner for the debts of his firm, and so for the purposes of this distinction this tax liability is a partnership debt. *Cf., In re Green*, 116 F. 118, 122 (N.D.Iowa, 1902).

claims of individual creditors requires us to consider next the operation of Section 68. Section 68a broadly permits setoff of claims between the bankrupt and a third party. It applies both where the third party's claim is the larger and he seeks to be "allowed" a share of the estate, and where the bankrupt's claim is the larger and the bankrupt seeks to be paid on his claim against the third party. The precise language of the section is that after setoff "the balance only shall be allowed or paid," that is, allowed by the trustee or paid by the third party. See 4 Collier on Bankruptcy §§ 68.02[1] and 68.03.[13] It is available as a defense in a suit by the trustee against a third party on a debt owed to the bankrupt. 4 Collier on Bankruptcy § 68.02[1], at 848-854.

Section 68 itself contains three distinct tests: mutuality, provability, and allowability. This case requires us to consider whether there is also a fourth factor, that of subordination or non-subordination.

A. Mutuality

The cases involving mutuality of debts between partnership, partner and third party can be divided into two basic factual situations. Both involve a third party who has a claim against one — partner or partnership — and who is in debt to the other — the partnership or the partner. In the first situation, the third party (C) has a claim against the partner (A) and is in debt to the partnership (AB), represented schematically as follows: AB — C — A. In the second

[13]The statute is misquoted in §68.02[1] of Collier, text at n. 2 where it reads "allowed and paid" instead of "allowed or paid."

situation, the third party has a claim against the partnership and is in debt to the partner, represented schematically as follows: A — C — AB.

[4, 5] Each of these two groups of relations can give rise to either of two situations, often termed by the cases as "reciprocal," corresponding to the different parties who can attempt to utilize setoff. In the first situation [AB — C — A], either the third party (C) or the partner (A) may seek to utilize a setoff. In case (a), the partner in debt to the third party may seek to offset against that claim the partnership's claim on the third party. In case (b), the third party in debt to the partnership may seek to offset against that claim his own claim on the partner. In neither case are the debts mutual, however, and in neither should the setoff be permitted. The reason is that in both cases B's share of the partnership claim against the third party is being taken away without B's consent and without any benefit to B since it is being set off against the third party's claim against A. A is relieved of his liability to C at the expense of the partnership, that is, both A and B. *Gray v. Rollo*, 85 U.S. (18 Wall.) 629, 21 L.Ed. 927 (1874) is an example of case (a); *In re T.M. Lesher & Son*, 176 F. 650 (E.D. Pa., 1910) and *In re Crystal Spring Bottling Co.*, 100 F. 265 (D.Vt., 1900) are examples of case (b).

[6, 7] In the second situation [A — C — AB] either the third party (C) or the partnership (AB) may seek to utilize a setoff. In case (c), one sued on the partnership debt to third party may attempt to set off against that claim the partner's claim against the third party. In case (d), the third party in debt to the partner may attempt to set off against that claim his own

claim against the partnership. In both cases the liability of both A and B is being exchanged for the claim of A. B gains and gives up nothing. A loses his sole claim against C, but he gains his release from the partnership debt for which he was severally liable in any event.[14] C loses his claim against B on the partnership debt, but he gains his release from the liability to the partner A. Examples of case (c) include *Beauregard v. Case*, 91 U.S. 134, 23 L.Ed. 263 (1875), *In re Shults*, 132 F. 573 (W.D.N.Y., 1904), and *In re Sherman Plastering Co.*, 346 F.2d 492 (CA2, 1965).[15] Examples of case (d) include *Tucker v. Oxley*, 9 U.S. (5 Cranch.) 34, 3 L.Ed. 29 (1809), *In re Neaderthal*, 225 F. 38 (CA2, 1915),[16] and the instant case.

All of the cases in this second situation may satisfy the requirement of mutuality where the partnership debt is joint and several, depending on exactly who seeks to exercise the right to set off. Thus no one has a claim extinguished without a corresponding gain. But the claim of the partner against the third party that is extinguished by being set off against the liability of the partnership may be more valuable to the partner than his freedom from liability for the partnership debt. Conversely, the third party loses a claim against B, the other partner, which may be more valuable to him than being

[14]What A may lose is his indemnification action against B on the partnership debt. This issue has never been raised in any of the cases cited to or by this court in this case.

[15]*Sherman Plastering* is not a partnership case but is analogous in terms of joint and several liabilities of companies as if they were partners. *See* footnotes 19 and 20, *infra*.

[16]The court wrongly characterized the case as being of the first type, either class (a) or (b). The case is discussed in some detail, *infra*, footnote 18.

freed from liability to A. Thus, in each case we must be clear that the party who is foregoing a potentially more valuable claim or who is avoiding a potentially less onerous liability has either consented to the exchange or has no right to protest.

In the class (d) situations the third party elects to assert the claim he has on the partnership against one of the partners, an option he has where the debt is joint and several, where that partner has brought his action against the third party. It is the third party (C) who is losing his potential claim against the other partner (B), but he does so only at his own choice. A has no right to complain, since C could have held him individually liable on the joint and several partnership debt in any event. In *Tucker v. Oxley, supra,* the third party, Tucker, attempted to set off his claim against the partnership against a claim being made on him by the remaining partner. He voluntarily chose to forego his claim on the departed partner and assert the partnership claim against the remaining partner. Setoff was properly allowed.[17]

Similarly, *In re Neaderthal,*[18] *supra,* it was the third party

[17]Note however that whether Tucker still had an action against the other partner is problematical. The partnership had dissolved and had not gone bankrupt, the remaining partner had assumed the rights and liabilities of the partnership, and Tucker, by continuing to deal with the remaining partner, may have consented to that arrangement and thus waived his right to proceed against the other partner. *See Sherman Plastering, supra,* 346 F.2d at 495, n.2.

[18]The difficulty in deciphering the obscure opinion in *Neaderthal* may be explained in part by the unusual factual situation. Samuel Neaderthal was a partner with two others. His mother loaned the firm $12,000 prior to her death in 1912. Firm and partners subsequently went bankrupt. Apparently the estates of all bankrupts were being handled by the same trustee. Samuel and another man were the executors of his mother's estate. The estate of the partnership owed the mother

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who wanted to forego part of his claim against the partnership on the note and to avoid liability to the partner on the legacy. As a matter of mutuality this setoff should have been permitted, as a later decision in the same circuit noted in disavowing *Neaderthal*'s analysis, *Sherman Plastering, supra.*

Another problem concerns whether the third party, as defendant, could set off against a partner's claim his own claim against the partnership for which the partner was only jointly liable. The third party would be giving up his claim against the partnership and the other partner, at his option. But the partner A would be subjected to a liability which the third party was obligated to assert first against the partnership. We have seen no case dealing with this exact point.

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footnote 18, continued

$12.000. The mother's estate owed the bankrupt son Samuel $2,400 from a residuary legacy in the mother's will. The executors filed a claim in bankruptcy for the $12,000 less the legacy of $2,400 owed to one of the partners. It was disallowed by the District Court on the protest of the trustees because it was too *small.* As trustees of the son's individual estate, the trustees in bankruptcy wanted to be able to collect the full $2,400, even though as trustees of the partnership estate they would have to pay a claim based on the $12,000 debt rather than the resulting set-off debt of only $9,600 (approximately). The latter, of course, would be paid at the rate owed to general creditors. As executor, Samuel wanted to be discharged of the liability for the legacy at the same rate that he would recoup the loan paid to the partnership, that is, the rate paid to all creditors of the estate of the partnership.

In essence the parties were litigating a claim against the bankrupt estate that was more logically litigated in an action by the trustee in bankruptcy against the third party debtors of the individual estate. It was only the circumstance of all estates being handled by one trustee that made it sensible for the partnership trustee to oppose a claim against the estate for being too small, knowing that he would be able to collect in his other capacity as individual trustee, and also avoid any possible res judicata effects of allowing the reduced partnership claim.

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The class (c) situations are less simple. The third party may elect to assert his claim against one of three entities: the partner to whom he is indebted, the partnership, or the other partner. It is only in the former case that setoff is properly allowed.

[8] In *Beauregard v. Case, supra,* the third party brought an action on the partnership liabiltiy against the "other partner" (B). The other partner attempted to utilize as setoff the claim against the third party owned by partner (A). The Court properly did not permit that setoff. The third party had elected, as it properly could, to lay the burden of the partnership debt on whichever of the partners it chose, and that partner had no cause to complain. Partner (A), who had a claim against the third party, could not be divested of that claim without either consent or being properly brought into the suit. In a sense this is not really a setoff problem at all. Thet claim put forward for setoff by the defendant simply was not his claim to assert in any event in any court, offensively or defensively.

The third party brought an action on the partnership liability against the partnership in *In re Shults, supra.* Again, the partnership did not own the partner's claim, and so, as in *Beauregard,* setoff was not allowed.

Sherman Plastering, supra, though not a partnership case. illustrates the situation where the action on the partnership

debt[19] is brought by the third party against the partner[20] to whom the third party is indebted. The creditor elected to lay the debt at the door of one to whom he was in turn indebted, and there was no reason why he should be able to avoid setoff, having made that election.[21]

The instant case is analogous to *Neaderthal* and *Tucker v. Oxley*. It is the United States as the third party which has foregone its claim against the partnership and the corporate partner and seeks to impose it all on the individual partner Wynne. Since the United States is the party urging setoff, its consent is implicit. The defendant partner here is not disadvantaged since the partnership is bankrupt and the partners are liable.

B. Provability and allowability under § 57g

The trustee does not challenge that this claim is provable or that it is allowable under § 57g, so we treat these two matters only briefly.

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[19]The debt was actually the joint and several debt of cosureties on a bond. Despite the factual difference, it is identical in terms of legal rights and liabilities to a partnership debt that is joint and several. That situation does not, however, come within the purview of §5g, which the court specifically noted.

[20]Actually a debtor jointly and severally liable. See the previous footnote.

[21]This case is unusual in its factual background, since the third party (the trustee in bankruptcy) had attempted to collect from the other joint obligers on the surety bond but was prevented from doing so by the District Court. That does not affect our analysis of mutuality, however. A single partner was still forced to bear the burden of the partnership debt. It does not matter that the election to sue that partner was forced on the third party by a bankruptcy court. It is all the same to that partner. As a question of mutuality between these two parties the practical realities, the analysis and the results are the same.

[9, 10] 1. *Provability:* Section 63, 11 U.S.C. § 103, generally defines claims provable in bankruptcy. Although taxes are not specifically listed, there is little question that they are generally provable. *Cf.*, § 64a(5), and see 3A Collier on Bankruptcy § 63.02 at 1761-1762. Nor is provability affected by the debtor's liability in common with the partnership and other partners. The test is whether the claimant could have maintained an action against the bankrupt. Partnership claims are provable against the estates of the partners. *Robinson v. Hamilton Wholesale Liquor Co.*, 132 F.2d 285 (CA6, 1942); *Matter of Kardos*, 17 F.2d 706 (CA2, 1927).

2. *Allowability:* Section 57g, 11 U.S.C. § 93g, requires creditors who have received "preferences, liens, conveyance, transfers, assignments, or encumbrances" to surrender the same as a pre-condition to allowance of their claims against the bankrupt estate. The government clearly did not receive a lien, conveyance, transfer, assignment or encumbrance. The only arguable point is whether it has received a preference.

[11] The meaning of the term preference in § 57g is the same as that term is used in § 60a(1), 11 U.S.C. § 96a(1), see 3 Collier on Bankruptcy § 57.19[3.1] at 311-312. No property has been transferred from the debtor to the creditor, as defined in § 60a(1). Thus, there has been no preference. *Cf.*, *New York County National Bank v. Massey*, 192 U.S. 138, 24 S.Ct. 199, 48 L.Ed. 380 (1904).

C. Setoff of subordinated claims

The question remains whether setoff is available when the

claim of the creditor is subordinated to other claims against the estate by § 5g. Rochelle argues that the distribution provisions of § 5g somehow "override" the set-off provisions of § 68a. No court has ruled on this precise point,[22] and so we must look to the structure of the statute and cases in analogous areas. We think the § 68 setoff provision contemplates the kind of problems posed by claims of varying vitality and has dealt with them as much as the drafters thought appropriate.

Our analysis of the relationship between § 68a and § 5g rests on the notion of *expressio unius est exclusio alterius.* Section 68a broadly permits setoff of all mutual claims. Section 68b "makes certain specific exceptions to this allowance of set-off," *New York County National Bank v. Massey, supra,* 192 U.S. at 145, 24 S.Ct. at 200, 48 L.Ed. at 383. It requires claims to be provable and then further limits that with a single precise exception of lack of allowability, though not lack of allowability generally but lack of allowability only under § 57g. A provable claim may not be allowable for any of a wide range of reasons. "Allowability implies, not only provability, but also validity. If for any reason the claim is improper, or if there be a good defense to it, it is not allowable, although it may be provable as a debt." *Williams & Co. v. U.S. Fidelity & Guaranty Co.,* 11 Ga.App. 635,

[22]The court in *Sherman Plastering,* in attempting to explain away the erroneous mutuality of debts analysis in *Neaderthal,* suggested that the result might be interpreted as promoting the policies of §5g, present in the Bankruptcy Act when *Neaderthal* was decided but not relied on or cited by that court, 346 F.2d at 495. The court's statement that §5g would prohibit setoff of a partnership creditor's claim on the individual estate's claim against the creditor—exactly this case—is dictum. The case before the court did not involve a partnership and did not involve any question under §5g.

75 S.E. 1067, 1070, *rev'd on other grounds*, 236 U.S. 549, 35 S.Ct. 289, 59 L.Ed. 713 (1915); *Lesser v. Gray*, 236 U.S. 70, 74-75, 35 S.Ct. 227, 59 L.Ed. 471, 475 (1915). A court may disallow a claim for reasons specifically related to bankruptcy, for example, that it was not proven on time under §57n, 11 U.S.C. § 93n, or was fraudulently obtained within the meaning of §§ 67d(1)-(4) and (6), 11 U.S.C. §§ 107d(1)-(4) and (6), or because of the close relation between the debtor and the claimant, such as close relatives, §§ 44a and 59e, 11 U.S.C. §§ 72a and 95e, or stockholders of officers of a corporate bankrupt, *Richardson's Executor v. Green*, 133 U.S. 30, 10 S.Ct. 280, 33 L.Ed. 516 (1890), or because it was held by a creditor who would not surrender a preference under § 57g. The trustee's defenses to claims include all the defenses of the original debtor, and these also go to allowability, *e.g.*, compromise, duress, fraud, limitations, statute of frauds, and the like. Subordination of provable claims may also be ordered in other situations as a species of disallowance, 3A Collier on Bankruptcy § 63.08.

Provable but disallowable claims utilized for setoff have usually involved claims not actually proven on time.[23] Viewing the matter somewhat more precisely in terms of subordinated rather than disallowed debts, the stronger arguments lie with the third party holding the subordinated debt. The holder of a disallowed claim is given more than priority over other creditors; he is given a benefit he would not have received

[23] *Willcox v. Goess*, 92 F.2d 8, 16 (CA2, 1937), *cert. denied* 303 U.S. 647, 58 S.Ct. 646, 82 L.Ed. 1108 (1938); *Norfolk v. W. Ry. Co. v. Graham*, 145 F. 809 CA4, 1906). *See* 4 Collier on Bankruptcy §68.08 at 890.

even if the bankrupt estate were adequate to pay all creditors in full. Where the debt is subordinated, by contrast, the lawful preference worked by § 68 setoff goes to one within the "hierarchy of claims" against the estate, one who would have shared in the estate if there were sufficient assets.

We have been able to locate only two cases involving setoff of subordinated claims. *In re Phoenix Hotel Co. of Lexington, Ky.*, 20 F.Supp. 240 (E.D.Ky., 1937), held that setoff was not available to subordinated claimants but its reasons are unpersuasive, and we decline to follow it.[24]

The Ninth Circuit held that a subordinated claimant could invoke setoff under § 68a. *Hayden v. Standard Accident Insurance Co.*, 316 F.2d 598 (CA9, 1963). Claimant was a surety of the bankrupt and had paid off part of a third party's claim against the bankrupt. Both the third party and the surety sought to recover from the bankrupt, the former for the remainder of the debt, the latter for that share of the debt already paid by it as surety. The court considered that the surety was subordinated by § 57i, 11 U.S.C. § 93i,[25] but that nonetheless its claim for indemnification could be set off against its own debt. 316 F.2d at 601. After noting that setoff is available for all provable claims with the limited exception

[24]The court considered the subordination issue on the erroneous basis that state law relating to setoffs controlled rather than federal law. It held that permitting setoff would give a preference to the creditor. But it had permitted setoff of nonsubordinated claims the holders of which were thereby given a like "preference." It held the debts were not mutual but relied on cases concerning unpaid stock subscriptions, a species of trust in bankruptcy law wholly unlike the status of the bondholder-creditor whose subordinated claim was in issue.

[25]A construction now made specific by a congressional amendment.

of claims disallowed under § 57g, the court reasoned that if denying setoff and requiring the surety to pay his debt into the estate were desired § 68 or § 57i could have been amended to provide that a surety's claim for indemnification was not provable for purposes of setoff. In the absence of such legislation the court held the claim for indemnification was provable within the meaning of § 68. *Id.* at 602.

Finally, although setoff is no longer to be considered generally available in reorganizations under § 77, 11 U.S.C. § 205,[26] earlier courts applying § 68 to setoffs in the reorganization context were expected to consider, inter alia, "the superior liens, if any, to that of the creditor seeking set-off . . . ." *Susquehanna Chemical Corp. v. Producers Bank & Trust Co.*, 174 F.2d 783, 787 (CA3, 1949). Consideration of superior creditors could only be necessary if the holders of subordinated claims might have setoff available in the first place.

[12] We think a subordinated claim can be used to set off a claim by the bankrupt estate against the creditor even though the subordinated claim could not itself share in the dividends. And we think this rule is applicable where the claim is subordinated by operation of § 5g. If Congress intended a different result it would have drawn § 68 more narrowly than to permit set-off of all provable claims generally with but a single narrow exception, or § 5g more broadly than merely to provide priority for distribution of assets.

Rochelle's other arguments are irrelevant or without merit. The United States concedes that penalty tax claims are not

[26] *Baker v. Gold Seal Liquors, Inc.*, 417 U.S. 467, 474, 94 S.Ct. 2504, 41 L.Ed.2d 24, 250 (1974).

allowable and says it so conceded to the trial court. Since a debtor in possession is liable for new debts it incurs, there is no plausible reasons why others jointly or jointly and severally liable for the debts of the debtor in possession should not also be liable for such debts. The argument that the partner should be held liable only for his aliquot share of the debts of the partnership is frivolous. Whether the United States must exhaust its claim on the partnership assets before attempting to utilize the setoff is resolved by the main part of this opinion. The estoppel questions are moot in light of our determination on the main setoff question.

[13] We thus hold that a tax claim of the government, like the claims of any creditor of a partnership, is a joint and several liability of the partners on the insolvency of the partnership. It is a provable debt of the partner not disallowed by § 57g. It and the tax refund claim of the partner against the government are mutual debts under the facts of this case. Finally, § 68 setoff is available between such claims notwithstanding the subordination of the partnership claims by § 5g.

The District Court did not err in permitting the setoff sought by the United States.

Affirmed.

UNITED STATES COURT OF APPEALS
For the Fifth Circuit

October Term, 1974

No. 74-1639

D. C. Docket Nos. CA-3-3398-C
CA-3-6146-C

William J. Rochelle, Jr., Trustee,

Plaintiff-Appellant,

versus

United States of America,

Defendant-Appellee.

Appeal from the United States District Court
for the Northern District of Texas

Before RIVES, GODBOLD and GEE, Circuit Judges.

JUDGMENT ON REHEARING

Plaintiff-appellant's petition for rehearing is granted;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby affirmed in part, and reversed in part, and that this cause be and the same is hereby remanded to the said District Court in accordance with the opinion of this Court;

It is further ordered that defendant-appellee pay to plaintiff-appellant, the costs on appeal to be taxed by the Clerk of this Court.

January 26, 1976

Issued as Mandate:

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UNITED STATES COURT OF APPEALS
For the Fifth Circuit

William J. Rochelle, Jr., Trustee,
Plaintiff-Appellant,

v.

United States of America,
Defendant-Appellee.

No. 74-1639

Jan. 26, 1976.

ON PETITION FOR REHEARING
(Opinion Oct. 24, 1975, 5 Cir. 1975, 521 F.2d 844)

Before RIVES, GODBOLD and GEE, Circuit Judges.

PER CURIAM:

The trustee points out that it has not received a refund of penalties and that no judgment has been entered for such a refund although, as we pointed out in our opinion, sl. op. p. 298, the United States concedes that penalties were not allowable in bankruptcy and states that it so conceded to the trial court. The trustee requests that we enter judgment for the full amount of the penalties. The United States, while reiterating that a refund of penalties is in order, asserts that judgment should be for less than the full amount. Since establishment of the correct amount to be refunded involves both questions of law and the effect of concessions made by the government in the trial court and not in the record before us, as well as concessions made in this court, the matter is for the District Court in the first instance.

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The petition of the trustee for rehearing is granted and the mandate is amended to provide that the judgment of the District Court is affirmed in part and reversed in part and the cause is remanded for the entry of a judgment in favor of the trustee in such amount as the District Court finds appropriate.

IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1975

No. 74-1639

William J. Rochelle, Jr., Trustee,

v.

United States of America,

Respondent

CERTIFICATE OF SERVICE

All parties required to be served with copies of the Appendix to the Petition for Writ of Certiorari have been served. Three copies of the Appendix to the Petition for Writ of Certiorari were served upon the Solicitor General by depositing same in a United States Mail Box, with air mail postage prepaid addressed to Solicitor General, Department of Justice, Washington, D.C. 20530, on the ..... day of March, 1976. Three copies of the Appendix to the Petition for Wrti of Certiorari were served upon the Department of Justice by depositing same in a United States Mail Box, with air mail postage prepaid addressed to Scot P. Crampton, Tax Division, Department of Justice, Washington, D.C. 20530, on the ..... day of March, 1976.

.....

Philip I. Palmer, Jr.

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APR 8 1976
MICHAEL RODAK, JR., CLERK

In the

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1396

WILLIAM J. ROCHELLE, JR., Trustee,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

SUPPLEMENTAL APPENDIX

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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United States District Court, N. D. Texas,
Dallas Division.

William J. Rochelle, Jr., Trustee in Bankruptcy of
Estate of Angus G. Wynne, Jr.

v.

United States of America (two cases).

Civ. A. Nos. 3-3398 and 3-6146.

Nov. 15, 1973.

MEMORANDUM OPINION

WILLIAM M. TAYLOR, Jr., Chief Judge.

These consolidated suits involve not only identical parties, but also the same essential question: who is entitled to possess an income tax refund of nearly a third of a million dollars. For reasons detailed in the pages that follow, I have decided that the United States acted correctly in setting off the refund against other taxes for which the taxpayer was liable.

The refund[1] on the 1962 Federal income tax of Angus G. Wynne, Jr., and his wife results from a loss carryback from 1964 directly attributable to losses sustained in 1964. Wynne was a joint venturer in Wynne-Compass Fair, Inc. (hereafter abbreviated to the Fair), which operated the financially unsuccessful Texas Pavilion at the New York World's Fair in 1964.

[1] The amount of the refund is $325,380.97 plus interest of $1,556.95, $326,947.92.

In September of 1964, involuntary bankruptcy proceedings were filed against Wynne in Dallas, his home town. The following September, while the bankruptcy case was still open (indeed, it still *is* open[2]) the Wynnes filed a claim for refund on their 1962 income tax in the amount mentioned in note 1. They make no claim to the money, having consented to have the refund credited to the unpaid federal taxes[3] owed by the Fair[4]. The plaintiff Rochelle, however, in his capacity as Wynne's bankruptcy trustee, filed an identical claim in January of 1968 and now contends that the refund should have been paid to him for the use of the bankrupt estate, not used to satisfy the partnership's federal tax obligation.[5]

[1] Initially, then, this Court is called upon to decide whether the United States acted rightly or wrongly in setting off the unpaid taxes of the partnership against the refund due to Wynne individually.[6]

---

[2] Wynne v. Rochelle, 385 F.2d 789 (5th Cir. 1967) reversed the district court's adjudication of Wynne as a bankrupt and remanded for a jury trial on the question of the exact date of bankruptcy, which has not been held. The Court's opinion explains much of the historical basis of the present litigation.

[3] While operating, Wynne-Compass Fair, Inc., incurred liability for the employer's portion of Social Security (F.I.C.A.) taxes, the amount withheld from employees' pay for Social Security and income taxes, Federal Unemployment Tax Act taxes and excise taxes totaling $349,679.02.

[4] Wynne-Compass Fair, Inc., was adjudicated bankrupt Aug. 18, 1964, following voluntary Chapter XI proceedings.

[5] In No. 3398, Plaintiff sued to recover a claimed overpayment in the Wynnes' 1962 income tax. In No. 6146 he sued for a refund of the amount credited against the tax obligation of Wynne-Compass Fair, Inc.

[6] The Wynnes apparently filed a joint tax return primarily because of Texas community property laws. For our purposes, Wynne will be treated as the sole taxpayer.

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Both parties cite — but reach different conclusions from — section 68 of the Bankruptcy Act (11 U.S.C. §108). The text is quoted in the margin,[7] but in essence the statute provides simply that if there are mutual debts between a bankrupt and a creditor, the account shall be stated and one debt shall be set off against the other with only the balance being paid. The section requires the existence of mutual debts, and that the debt due from the bankrupt be provable.

Plaintiff contends that the statute is permissive rather than mandatory, despite its language, and that at any rate the debts and credits must be between the same parties standing in the same capacity. Plaintiff also cites the familiar general rule that the joint debts (here, the tax obligation of the Fair) cannot be set off against joint debts.

The defendant, on the other hand, maintains that "mutual debts" exist even where a creditor (the Government) of a bankrupt partnership (the Fair)[8] owes a debt to *one* of the partners (Wynne).

In addition, Rochelle quotes section 5(g) of the Bankruptcy Act (11 U.S.C. 23), dealing with partnerships, which says that

[7] "a. In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.

"b. A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate . . . or (2) was purchased by or transferred to him after the filing of the petition or within four months before such filing, with a view to such use and with knowledge or notice that such bankrupt was insolvent, or had committed an act of bankruptcy."

[8] Treasury Regulations on Income Tax sec. 301.7701-3(a) treat a joint venture as a partnership for tax purposes.

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net proceeds of partnership property shall be appropriated to the payment of partnership debts; and the net proceeds of the individual estate of each general partner, to the payment of his individual debts. Any surplus remaining in either estate is to be applied against the other estate's debts. This statute, Rochelle insists, is mandatory and precludes the offset, because the income tax refund claim was an individual asset while the Fair's tax obligation was a partnership liability.

I have concluded that the parties did hold mutual debts and that the Government's claim against Wynne was provable in bankruptcy. The setoff, then, was proper.

The Bankruptcy Act with which we deal here is certainly not of recent vintage, but cases predating it support the Government's contention that Wynne and the Government held mutual debts. Tucker v. Oxley, 9 U.S. 34 (5 Cranch 34) 3 L.Ed 29 (1809); Gray v. Rollo, 85 U.S. 629 (18 Wall. 629), 21 L.Ed. 927 (1873). More recent and more on point, however, is In re Sherman Plastering Corp., 346 F.2d 492 (2d Cir. 1965), a case dealing specifically with section 68 of the current act (and interpreting the *Tucker* and *Gray* cases). Sherman, like the Fair, was allowed for a time to operate its business as a debtor-in-possession following the filing of a petition for a Chapter XI arrangement. Sherman was a judgment creditor of three companies which were held jointly liable. One of the three sought to pay its pro rata share of the judgment by offsetting it by an unrelated debt due to it from Sherman. Sherman resisted the setoff, as Rochelle does here, by invoking the maxim that a joint debt (the one owed by the company) cannot be set off by

a single debt (the debt owed by Sherman). Circuit Judge Marshall wrote:

> No legitimate interest would be served by disallowing this set-off, and in fact disallowing the set-off would frustrate the manifest equitable purposes of section 68. It would put Hanover [the company] in the inequitable position of having to pay its debt to Sherman in full while receiving only partial satisfaction of its claim against Sherman. Neither the rehabilitative purposes of a Chapter XI arrangement nor section 68's requirement that the debts be mutual dictates such a result.
>
> * * * * * *
>
> The venerable maxim that a joint debt cannot be set off against a separate debt, and vice versa, . . . like all maxims tested by experience, has its exceptions, and this is one of them. 346 F.2d at 493, 496-497.

The same court in an earlier case chose to adhere to the maxim rather than its exception and Rochelle naturally points to the case, In re Neaderthal, 225 F. 38 (2d Cir.), cert. denied, 238 U.S. 635, 35 S.Ct. 939, 59 L.Ed. 1499 (1915), as holding that a partnership creditor cannot discharge an obligation owed to one of the partners individually by setting off the debt owed to the creditor by the partnership. But as Judge Marshall said of another aspect of *Neaderthal*, ". . . to the extent that it is so read, we choose not to follow it." In re Sherman, supra, 346 F.2d at 495. The *Neaderthal* opinion does not mention, let alone distinguish, the earlier conflicting cases of *Tucker* and *Gray*, supra. In *Sherman*, Judge Marshall questioned the reasoning of *Neaderthal*, found it inconsistent with precedent, and, as mentioned above, declined to follow it. I also decline to follow it.

By offsetting the taxes due it against the refund payable to

Wynne, the Government is being paid more than other creditors of the same or prior class. The same situation was presented in In re Inland Waterways, 71 F.Supp. 134 (D.Minn.1947). There the U. S. Navy owed money to the bankrupt shipbuilder, but instead of paying the full sum owed, the Government deducted the amount owed by the firm for its workers' employment and withholding taxes. The district court recognized that the setoff created a preference for the Government, but held (over the trustee's potest) that the offset was proper.[9]

In addition to the existence of mutual debts, section 68 also requires that the claim be provable in order for a setoff to be proper. In Lewis v. United States, 92 U.S. 618, 23 L.Ed. 513 (1875), a partnership that was indebted to the Government was bankrupt, as were the partners individually. The Supreme Court found that the partnership's debt was also a debt owed by the individual partners:

> The court below committed no error in holding that the preference of the United States, as a creditor of [the bankrupt partnership] applied to the separate and individual estates of the bankrupt partners; thus superseding the rule in equity recognized by the Bankrupt Act, that partnership property is to be first applied in payment of the partnership debts, and individual property in payment of the individual debts. 92 U.S. at 624, 23 L.Ed. 513.

[2, 3] It is inherent in the Court's decision that a partnership's debt is a "provable debt" against the individual bankrupt partners. I find that the Government was a creditor of Wynne's individual estate in bankruptcy, just as it was a creditor of the Fair's estate in bankruptcy. And the Government's claims

[9] This holding was not affected in the reversal, on the Government's appeal, of the case. United States v. Fogarty, 164 F.2d (8th Cir. 1947).

against Wynne for the unpaid taxes of the Fair were provable in his individual estate.

Because Wynne's tax refund claim for 1962 and the Government's claim against him for the Fair's taxes were "mutual debts," and because the Government's claim against Wynne for the Fair's taxes was provable in bankruptcy, then the Government may set off the two amounts in accordance with §68(a) of the Bankruptcy Act.

[4] Rochelle insists that no matter what §68 says, §5(g) has priority over all conflicting considerations and requires allocating the assets between partnership and individual creditors.[10] To allow a setoff, says Rochelle, would be unfair to Wynne's creditors under the rule of distribution of §5(g) requiring that individual creditors, not partnership creditors, should have priority in the bankrupt partner's individual estate. The Government, answering this contention, cites Francis v. McNeal, 228 U.S. 695, 33 S.Ct. 701, 57 L.Ed. 1029 (1913), a case involving an individual partner's liability *vel non* for debts of a bankrupt partnership. The Court found it true that

> partnership debts are debts of the members of the firm,

[10] "Sec. 5. Partners . . . .

"(g) The net proceeds of the partnership property shall be appropriated to the payment of the partnership debts and the net proceeds of the individual estate of each general partner to the payment of his individual debts. Should any surplus remain of the property of any general partner after paying his individual debts, such surplus shall be added to the partnership assets and be applied to the payment of the partnership debts. Should any surplus of the partnership property remain after paying the partnership debts, such surplus shall be distributed among the individual partners, general or limited, or added to the estates of the general partners, as the case may be, in the proportion of their respective interests in the partnership and in the order of distribution provided by the laws of the State applicable thereto."

> and that the individual liability of the members is not collateral like that of a surety, but primary and direct, whatever priorities there may be in the marshaling of assets. 228 U.S. at 699-700, 33 S.Ct. at 702.

Francis would suggest, then, that §5(g) does not affect Wynne's debt to the Government; its claim against him individually for the Fair's unpaid taxes is a valid one. Section 5(g), instead, simply establishes a statutory priority of payment by marshaling assets. The section does not interfere with the setoff permitted by §68(a) — not even if §68(a) operates to permit a preference by allowing one creditor to be paid more than another creditor of the same or a higher class. See In re Inland Waterways, *supra*.

Since Rochelle, as noted in the preceding paragraph, is concerned with what is fair to Wynne's creditors, it is appropriate at this point to acknowledge that the Court need not close its eyes to the relative equities in this situation. *See* Gardner v. Chicago Title & Trust Co., 261 U.S. 453, 43 S.Ct. 424, 67 L.Ed. 741 (1923); 9 Am.Jur.2d Bankruptcy §512 (1963). The Government counters that if equity is to be considered, the Court should recognize the inequity of requiring the Internal Revenue Service to refund $326,947.92 in full to Wynne while Wynne postpones paying the Government the Fair's taxes until all other creditors of his estate have been paid. When it is remembered that Wynne would have no refund coming at all but for his misadventures with the New York World's Fair — misadventures that led to the partnership's debt to the Government — the inequity mentioned by the Government becomes more acute. It hardly seems like fair play to the Court to pour

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a third of a million dollars into Wynne's estate in bankruptcy for creditors' benefit while simultaneously requiring the Government to take its place in line to try to recover the taxes due it from Wynne as a partner in the Fair. In sum, then, the equities are with the Government.

[5] On another tack, Rochelle challenges the propriety of the setoff because, he says, the Government has not pursued to the end the partnership proceedings to satisfy its tax claim. It appears to the Court that the Government does have a claim in the partnership proceeding — although for only $72.76. Previously the amount claimed there was in excess of $2 million. I decline to require the Government to exhaust the partnership funds before asserting its claim against Wynne individually because of the uncertainty that the Government could collect anything at all in that manner. Moreover, I find no impropriety in the Government's reduction of its claim against the partnership funds. The initial $2 million claim was based on estimated liablities which subsequently were reduced to approximately those at issue in this case. After the Government applied the setoff, there was no need for it to continue asserting its claim for that amount in the bankruptcy proceeding.

II.

[6] On January 2, 1968, Rochelle (as bankruptcy trustee for Wynne) signed an IRS Form 870, "Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Over-assessment." Although Rochelle testified that he did not *intend* to waive the estate's claim to the tax refund, the Government could hardly be expected to know what Rochelle's

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intent was or was not. Instead, the Government took the form for what it purported to be: an agreement that the amount of Wynne's overpayment of his 1962 income taxes was to be applied against the Fair's unpaid taxes. Acting in reliance on this agreement, the Government then changed its position to its detriment by reducing its claim in the partnership proceedings to $72.76. Rochelle is estopped from repudiating his agreement, regardless of his intent or lack of intent at the time of executing the agreement. This conclusion is largely academic, however, since the discussion in Section I, *supra*, actually determines the outcome of this case.

III.

[7] Rochelle next contends that Wynne individually cannot be charged with the various federal taxes which fell due after July 16, 1964, the date that the Fair's Chapter XI proceeding was begun. Rather, he says, those taxes are only costs of administration in the partnership proceeding. Rochelle cites Standard Oil Co. of New Jersey v. Elliott, 80 F.2d 158 (4th Cir. 1935) as support for his argument that Wynne's individual creditors may not be forced to bear administrative costs incurred by the partnership during the weeks it was debtor-in-possession. The Government correctly challenges the relevance of that case to this one. Here Wynne did not become involved in individual bankruptcy proceedings until some time *after* the Fair's Chapter XI proceeding was filed. The Chapter XI matter in no way insulated Wynne individually from liability for taxes incurred by the Fair as debtor-in-possession. In *Standard Oil* (which apparently was not a bankruptcy case), the court

disallowed a setoff of a pre-existing debt owed to a tenant by a landlord against rent owed by the tenant to the landlord bank after the bank was in receivership.

As a variation on this theme, Rochelle says that the Court ought to apportion the Fair's taxes that arose after July 16, 1964, on the basis (apparently) of the time the Fair operated as debtor-in-possession. In other words, to take the Federal unemployment taxes as an example, one of Rochelle's contentions is that about one-seventh ($8,102.11) of the Fair's 1964 taxes in this category ($56,714.79) are administration expenses. He fails to explain from whence came the fraction of one-seventh, but the Court will go along with the Government's educated assumption that it is derived from the fact that the Fair operated as debtor-in-possession for about one month of the seven months in 1964 ending with the liquidating bankruptcy. But an allocation based on time alone, even if sufficiently precise, would not necessarily be a correct allocation of Federal unemployment taxes because there is no evidence that the partnership's payroll was level throughout the seven months. Given the financial problems the partnership was having, it would seem logical that the employment probably dropped off toward the end. At any rate, Rochelle has failed to carry his burden to establish every element of his claim for a refund of taxes paid. Helvering v. Taylor, 293 U.S. 507, 55 S.Ct. 287, 79 L.Ed. 623 (1935).

IV.

The final question is whether Rochelle is correct in maintaining that one-half of certain of the Fair's unpaid taxes that

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were set off should be disallowed because Wynne and the Fair are equally responsible for them, and that it would be inequitable to Wynne's estate's creditors to use the estate's assets to satisfy the partnership's share of the taxes. Not only is Rochelle unable to cite more than a footnote to support his argument,[11] but also he fails to explain why he thinks Wynne's obligation is anything other than joint and several. I see no reason in equity or otherwise that the Government could not collect the partnership's taxes in full from Wynne, a partner, under the circumstances. I believe this has been sufficiently discusssed above.

The United States is entitled to set off the entire amount of its claim against Wynne for the Fair's taxes against the income tax refund due to Wynne individually.

Judgment will be entered for the defendant. Defendant's lawyers are requested to submit appropriate form.

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[11]In re Sherman Plastering Corp., 346 F.2d 492, 496 n. 3 (2d Cir. 1965).

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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1975

No. 75-1396

William J. Rochelle, Jr., Trustee,

v.

United States of America,

Respondent

CERTIFICATE OF SERVICE

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.....

Philip I. Palmer, Jr.

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Internal Revenue Code of 1954 (26 U.S.C.), Section 172 3

Miscellaneous:

4 Collier on *Bankruptcy* (14th ed., 1975) 5, 6

8 Collier on *Bankruptcy* (14th ed., 1975) 8, 9

In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1396

WILLIAM J. ROCHELLE, JR., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (Pet. Supp. App. 1-12) is reported at 371 F. Supp. 224. The opinion of the court of appeals (Pet. App. A-3 to A-25) is reported at 521 F.2d 844. The court of appeals' amendment to its opinion on rehearing (Pet. App. A-27 to A-28) is reported at 526 F.2d 405.

JURISDICTION

The judgment of the court of appeals on rehearing was entered on January 26, 1976 (Pet. App. A-26). The petition for a writ of certiorari was filed on April 2, 1976. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the government may set off a claim for unpaid taxes of a partnership against a debt it owes the estate of

a bankrupt partner pursuant to Section 68 of the Bankruptcy Act when the tax claim is subordinate to the claims of creditors of the partner in his individual capacity under Section 5g of the Bankruptcy Act.

STATUTES INVOLVED

Section 68 of the Bankruptcy Act, 30 Stat. 565, as amended, 11 U.S.C. 108, is set forth at pp. 3-4 of the petition. Because there are various errors in the reproduction of Section 5g of the Bankruptcy Act, 30 Stat. 548, as amended, 11 U.S.C. 23(g), in the petition (p. 3), we set forth that provision below:

> §23. Partners.
>
> (g) The net proceeds of the partnership property shall be appropriated to the payment of the partnership debts and the net proceeds of the individual estate of each general partner to the payment of his individual debts. Should any surplus remain of the property of any general partner after paying his individual debts, such surplus shall be added to the partnership assets and be applied to the payment of the partnership debts. Should any surplus of the partnership property remain after paying the partnership debts, such surplus shall be distributed among the individual partners, general or limited, or added to the estates of the general partners, as the case may be, in the proportion of their respective interests in the partnership and in the order of distribution provided by the laws of the State applicable thereto.

STATEMENT

Angus G. Wynne, Jr., and Compass Fair, Inc., a New York corporation, formed a New York partnership, Wynne-Compass Fair, Inc., to operate the Texas pavilion at the 1964 New York World's Fair. The partnership proved unsuccessful, and on July 16, 1964, Wynne-Compass

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filed a petition for an arrangement of its debts under Chapter XI of the Bankruptcy Act, 11 U.S.C. 701 *et seq.*, in the United States District Court for the Southern District of New York. The partnership continued to operate its business as a debtor in possession until August 18, 1964, when it was adjudicated a bankrupt (Pet. App. A-4 to A-5; R. 12-13).[1]

During its operations, Wynne-Compass incurred liability for the employee's portion of Federal Insurance Contribution Act (F.I.C.A.) and income taxes, the employer's portion of F.I.C.A. taxes, Federal Unemployment Tax Act (F.U.T.A.) taxes, and excise taxes (Pet. App. A-5; Supp. App. 2 and n. 3). In September 1964, involuntary bankruptcy proceedings were filed against Wynne in the United States District Court for the Northern District of Texas, and Wynne was adjudicated a bankrupt two months later. The government thereafter filed proofs of claim for $349,679.02 in unpaid employment and excise taxes owed by Wynne-Compass in the bankruptcy proceedings of both the partnership and Wynne (Pet. App. A-5).

As a result of the unsuccessful operation of the partnership, Wynne had a net operating loss for 1964. Pursuant to Section 172 of the Internal Revenue Code (26 U.S.C.), Wynne was eligible to "carry back" the 1964 loss to 1962 and receive a $325,380.97 tax refund for the earlier year. In 1968, petitioner, as trustee of Wynne's bankrupt estate, filed a claim for refund for this amount. Although the government allowed the claim for refund, it retained the tax refund as a set-off against the unpaid tax liability of the

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[1] "R." refers to the record appendix in the court of appeals.

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partnership under Section 68a of the Bankruptcy Act, (11 U.S.C. 108(a)) (Pet. App. A-5; R. 14-16).[2]

Petitioner thereupon instituted these refund suits which were consolidated. The district court upheld the government's right to set-off Wynne's tax refund against the partnership tax liability (Pet. Supp. App. 1-12). The court of appeals affirmed (Pet. App. A-1 to A-25). It first concluded that because the government's tax claims originated in the operation of the partnership, they were subordinate to the claims of creditors of Wynne in his individual capacity, under Section 5g of the Bankruptcy Act (11 U.S.C. 23(g)). However, the court held that Wynne's claim for a tax refund and the government's claim for taxes were mutual debts under Section 68a of the Bankruptcy Act so that set off of the two claims was proper (Pet. App. A-6 to A-25).[3]

ARGUMENT

1. Section 68a of the Bankruptcy Act provides that in all cases of mutual debts between the estate of a bankrupt and a creditor, "the account shall be stated and one debt

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[2]Although petitioner had originally agreed in writing to such a setoff when he filed the claim for refund in 1968 (Pet. App. A-5, n. 4), he subsequently contended that he had not intended to waive his right to the tax refund as trustee of Wynne's bankruptcy estate. The district court held that petitioner was estopped from repudiating his earlier agreement (Pet. Supp. App. 9-10). In light of its disposition on the merits, the court of appeals did not consider the issue of estoppel (Pet. App. A-5, n. 4, A-25).

[3]Because a portion of the government tax claims against the partnership represented pre-petition penalties, the court of appeals remanded the case to the district court for a determination of the amount of the penalties that were satisfied in the set-off. The government had conceded that such penalties were not allowable claims in bankruptcy, and that a refund of the penalties was proper (Pet. App. A-27 to A-28).

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shall be set off against the other, and the balance only shall be allowed or paid." Set-off against the bankrupt's estate requires that the debts running between the bankrupt and the creditor asserting the right of set-off be mutual, and that the debt the bankrupt owes the creditor be provable against the estate of the bankrupt and allowable under Section 57g of the Bankruptcy Act (11 U.S.C. 93(g)). 4 Collier on *Bankruptcy*, par. 68.04[1] (14th ed., 1975).

The decision below correctly held that set-off was appropriate in this case. As the court of appeals observed (Pet. App. A-19 to A-20), petitioner has never asserted that the government's tax claims were not provable against Wynne's estate under Section 63 of the Bankruptcy Act (11 U.S.C. 103), or that they were not allowable under Section 57g. Moreover, the government's tax claims and the bankrupt's claim for a loss-carryback tax refund were "mutual debts" within the meaning of Section 68a.

It is well established that for purposes of Section 68 of the Bankruptcy Act, debts are mutual when they are "between the same parties, standing in the same capacity." 4 Collier on *Bankruptcy, supra,* at par. 68.04 [2.1]. Here, the debts satisfy this requirement. Wynne had become individually liable for the taxes incurred by his partnership prior to his bankruptcy (Pet. App. A-6 to A-8), and he had also accrued a claim for a loss-carryback tax refund of his 1962 income taxes by virtue of his share of the partnership losses incurred in 1964. See *Segal* v. *Rochelle,* 382 U.S. 375. Thus, both the government's claim against Wynne and Wynne's claim for a tax refund against the government are claims "between the same parties, standing in the same capacity." These are therefore mutual debts subject to set-off under Section 68a of the Bankruptcy Act.

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Contrary to petitioner's argument, the fact that the government's claim for taxes is subordinated to the claims of individual creditors of Wynne under Section 5g of the Bankruptcy Act does not require a different result.[4] As the court of appeals correctly stated (Pet. App. A-24), nothing in Sections 68 or 5g indicates that set-off should not be allowed where the debt asserted against the bankrupt's estate is subordinated to the claims of other creditors of the estate. See *Hayden* v. *Standard Accident Insurance Co.*, 316 F.2d 598 (C.A. 9). See also *New York County Bank* v. *Massey*, 192 U.S. 138, 145-147.

Bayliss v. *Rood*, 424 F.2d 142 (C.A. 4), and *In re Brewster-Raymond Co.*, 344 F.2d 903 (C.A. 6), relied upon by petitioner, are distinguishable. In *Bayliss*, the creditors seeking to assert a set-off had expressly agreed that their debts to the bankrupt would be "without off-set" (424 F.2d at 147).[5] In *Brewster-Raymond Co.*, the government sought after bankruptcy to set-off pre-petition penalties owed by the bankrupt against monies owed the bankrupt for performing a government contract. The court rejected the government's claim for a set-off because penalties were not an allowable claim against the bankrupt under Section 57j of the Bankruptcy Act (344 F.2d at 908-909). Here,

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[4]The government did not argue below that the subordination provisions of Section 5g were inapplicable to the United States as a partnership creditor (see *Lewis* v. *United States*, 92 U.S. 618, 620-621), or that it was entitled to a statutory priority over individual creditors of Wynne's estate despite Section 5g (Pet. App. A-9, n. 7). Cf. *In re Montgomery*, C.A. 9, Nos. 75-2442, 75-2443, decided March 18, 1976.

[5]The Fourth Circuit also held in *Bayliss* (424 F.2d at 147) that the creditors would not in any event be entitled to set-off because they stood in a fiduciary capacity toward the bankrupt. Under such circumstances, it is settled that the debts are not mutual because the parties are not standing in the same capacity. Thus, set-off is not possible. See 4 Collier on *Bankruptcy*, *supra*, at par. 68.04 [2.1].

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however, as the court of appeals noted (Pet. App. A-22 to A-23), the government stands in a different position because the claim for partnership taxes is merely subordinated to the claims of individual creditors of Wynne, and is not completely disallowed from Wynne's estate.[6]

Finally, petitioner asserts (Pet. 9) that the decision below works an unfairness by permitting the appropriation of the largest asset of the individual estate exclusively for the benefit of a single partnership creditor. But the refund of taxes sought by Wynne's estate is directly attributable to the unsuccessful partnership operations during which the partnership failed to pay its taxes (R. 14). Petitioner's position would result in the anomaly that the government would be required to pay the full amount of Wynne's tax refund and thereafter assume a subordinated position among Wynne's creditors for payment of its tax claims. No legitimate interest would be served by disallowing the set-off in these circumstances. As this Court has recognized, the equitable set-off provisions of Section 68a operate to establish a lawful preference of one creditor over others. *New York County Bank* v. *Massey*, *supra*, 192 U.S. at 146-148; *Cumberland Glass Co.* v. *De Witt*, 237 U.S. 447, 454-455. See also *In re Sherman Plastering Corp.*, 346 F.2d 492, 493 (C.A. 2).

2. Petitioner further argues (Pet. 8) that the decision below conflicts with *In re Neaderthal*, 225 Fed. 38 (C.C.A. 2), certiorari denied *sub nom. Freundlich* v. *Eisenbach*, 238 U.S. 635. There, the court refused to permit a creditor of a bankrupt partnership to set-off a debt it owed one of the partners on the ground that the debts were not mutual (225 F.2d at 39). However, the mutuality analysis of *Neaderthal*

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[6]Indeed, the government conceded that pre-petition penalties assessed against the partnership were not to be set off against Wynne's tax refund. See n. 3, *supra*.

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is no longer viable authority in the Second Circuit. In *In re Sherman Plastering Corp., supra*, 346 F.2d at 495, that court expressly "chose not to follow" that aspect of *Neaderthal*. Indeed, the mutuality analysis of *Sherman Plastering*, in which a surety under a joint and several obligation to a debtor in possession was held to be able to set-off a claim against the debtor in possession arising out of a prior transaction in which it was a surety for the debtor, is fully in accord with the decision below.

There is, moreover, no conflict with *Sherman Plastering*. While the court there suggested that the set-off of a partnership debt against a debt owed to one of the partners would be unfair to the individual creditors of the bankrupt partner, that statement, as the court of appeals here noted (Pet. App. A-21, n. 22), was dictum. *Sherman Plastering* did not involve a partnership and therefore did not concern the interplay between Sections 5g and 68a. Thus, as the court of appeals correctly concluded (Pet. App. A-21), "[n]o court has ruled on this precise point * * *."

3. Petitioner further contends (Pet. 11-14) that the decision below is erroneous insofar as it permits the government to set-off against Wynne's claim for refund of the taxes incurred by Wynne-Compass while it operated as a debtor in possession. Petitioner asserts that Wynne is not individually liable for those taxes because Wynne was not a partner of the debtor in possession.

Petitioner's assertion that Wynne was not a partner of the debtor in possession is erroneous. To be sure, a debtor in possession has a status separate from and additional to its status as the debtor. See generally 8 Collier on *Bankruptcy*, pars. 6.25-6.32 (14th ed., 1975). The debtor in possession is responsible for the operation of the business under the supervision of the court, while the debtor is responsible for preparing and submitting the plan of arrangement. But here, where the partnership operated as the debtor in

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possession, both of these responsibilities devolved upon the partnership. 8 Collier on *Bankruptcy, supra,* at par. 6.31; *Cle-Ware Industries, Inc.* v. *Sokolsky*, 493 F.2d 863, 869-871 (C.A. 6), certiorari denied, 419 U.S. 829. Those such as Wynne, who are jointly or jointly and severally liable for the obligations of the debtor, are individually liable for debts incurred by the debtor while operating as debtor in possession. See Section 397 of the Bankrupty Act (11 U.S.C. 797). The partnership taxes incurred during the arrangement proceedings are therefore mutual with Wynne's tax refund claim. Thus, as applied to the facts of this case, petitioner cannot characterize the debtor in possession as a legal entity entirely separate and distinct from the partnership-debtor.

4. Finally, petitioner argues (Pet. 14-15) that even if Section 68 permits set-off of a partnership debt against a debt due one of the partners, the set-off should not be permitted until the assets of the partnership estate are exhausted. But rejection of this contention follows from the court's disposition of the question whether subordination of the government's tax claim precludes its right of set-off against Wynne's tax refund claim. If, as petitioner assumes at this juncture, Section 68a permits the set-off of a subordinated partnership claim against a bankrupt partner, the set-off principle of Section 68 is applicable whether or not the assets of the partnership estate are exhausted (Pet. App. A-25).

Moreover, there is no authority for the proposition that Section 5g requires exhaustion of the partnership estate before partnership claims can be asserted against the estates of individual partners.[7] Indeed, Section 5g ex-

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[7] *Tucker* v. *Oxley*, 5 Cranch 34, relied upon by petitioner (Pet. 15), does not support his construction of Section 5g because it antedates the enactment of the original predecessor of Section 5g.

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pressly provides that any surplus remaining in the partner's estate after satisfaction of the claims of individual creditors shall be made part of the partnership estate and be applied to the payment of the partnership debts. Under the statute, the exhaustion of the partnership estate is not a prerequisite to such a transfer of surplus assets.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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